OFFICE OF THE ATTORNEY GENERAL OF TEXAS

AUSTIN

GERALD C. MANN
ATTORNEY GENERAL

Honorable O. P. Lockhart, Chairman
Board of Insurance Commissioners
Austin, Texas

Dear Sir: Opinion No. O-5052
Re: Does the proposed form of participating clause or endorsement to be attached to life policies by a domestic stock life insurance company violate any of the provisions of Articles 4729, 4753, 5036 or 5053, Vernon's Annotated Civil Statutes or Article 578, Penal Code, or any other applicable provisions? And related matters.

We have your letters of January 15, and February 15, 1943, requesting the opinion of this department on the above stated matter. We quote from your letter of January 15, 1943, as follows:

". . . .

"We desire your opinion as to whether such form violates any of the provisions of Articles 4729, 4753, 5036, and 5053, R.C.S., or Article 578, Penal Code, or any other applicable statutory provisions; and as to whether this Board has discretion to refuse to approve and file such form, upon any of the grounds of objections hereinafter stated.

". . . .

"Our principal objections to the clause are as follows:

"(1) Article 5053, R.C.S., and P.C. Article 578 define certain actions as constituting

forbidden discrimination and rebating, among which acts are the offer, sale, or other disposition of stock, or other rights and securities not expressed in the policy as an inducement to insurance. It seems to us that the clause, here under consideration, primarily violates the spirit and comes within the meaning if not the letter of Article 5053 and P. C. Article 578 in that it places the policyholder upon absolutely the same footing with the owner of whatever number of shares of stock are inserted in the blank; and that the policyholder's status is not simply that of a common stockholder, but that of a preferred stockholder, owning the number of shares therein set forth; and thus the policyholder has all the benefits of a common or preferred stockholder, without any of the burdens of such a stockholder, and without even the nominal ownership of a single stock share in the company.

"(2) The clause may be peculiarly misleading to the prospective policyholder, and peculiarly susceptible to misrepresentation to him, as to the amount of dividends to be realized under such clause. Assume, for instance, that in order to sell a $1,000 life policy the agent offers the prospect a participating rider in this form filled in in such way as to entitle him to dividends equal to those on five or ten shares of common or preferred stock. This sounds like a bonanza. The agent emphasizes that this entitles the policyholder to dividends equal to those on five or ten shares as if he owned them, without even having to buy or pay for or assume the ownership, risk, burdens, and bother of the shares. The agent then paints a rosy picture as to past earnings of the company, and prospective future earnings, and makes it sound like the dividends alone will more than pay for the policy; whereas, in truth, if the shares of stock be non-par value or even par value, with small value per share, such as $10, or even in any conceivable situation, the actual dividends may be smaller than represented and smaller than those ordinarily paid on other participating policies, and thus the policyholder is deceived and misled to his serious injury."

Your letter of February 15, 1943, is in part as follows:

"In order that the factual circumstances upon which we desire the requested opinion to be predicated may appear with greater exactitude, allow us to amend and supplement our original request of January 15, 1943, in the following respects:

"The particular participation clause quoted in the second paragraph of our original letter is not now pending original approval and filing by our Department under Article 4749, but has already been filed, with our implied approval, and is being used currently in connection with approved forms of policies. In addition to the quoted clause, we have already on file other forms of participating clauses, substantially identical with the quoted form, but perhaps with slightly different wording, used by other companies.

"In addition to asking your opinion as to whether the quoted form and all other forms with substantially identical provisions violate any of the terms of Articles 4729, 4753, 5036, and especially 5053, we desire your opinion also, in event you hold that the quoted form violates any of the provisions of any of such cited articles, as to whether we have the power and duty in the stated circumstances to withdraw our approval of such offending forms and require discontinuance of their use in the future, having already impliedly approved them under Article 4749 by filing them. To the extent that the first paragraph of our original letter may have conveyed the impression that the forms in question are submitted originally and are now pending approval for the first time, the original inquiry is hereby amended.

"In the case of the company using the precise form quoted in the second paragraph of our original letter, it is represented to us the stockholders have by appropriate written record consented that dividends to policyholders in accordance with such quoted provision should be paid

before or at the same time dividends shall be paid on the stock of the company. We desire your opinion also as to whether this circumstance has any proper bearing upon the legality or illegality of the form as complying with the four articles above cited. The reason we desire your opinion upon this additional point is that in the case of other companies using substantially the same form or participating clause, there may or may not have been action, taken of Record by the stockholders of the company involved, consenting to the payment of dividends to policyholders in accordance with the particular participating clause involved; and we, therefore, desire to know whether such consent, or the lack of such consent, on the part of the stockholders would have any proper bearing upon the compliance or noncompliance of the participating clause with the cited articles. In other words the opinion is not desired simply for the limited purpose of taking proper action, if any, with respect to the particular quoted clause, but also for our guidance in passing upon substantially identical forms, whether already filed or to be tendered for filing in future. It seems to us that injury or absence of injury to and complaint on the part of stockholders is no proper criterion for determining conformity or non-conformity to the statutory provisions cited.

". . . ."

The participating clause or certificate to be attached to life policies of a domestic stock life insurance company, incorporated under Chapter 3, Title 78, Vernon's Annotated Civil Statutes, is as follows:

"Attached to and forming a part of Policy No. _____ issued on the life of _____ the insured.

"This policy shall participate in the surplus earnings of the Company as apportioned by the Board of Directors, beginning not later than the end of the second policy year and annually thereafter while this policy is in full force. Such

dividends shall accrue from Mortality Savings, Reserves released on lapsed policies, excess interest earnings and other profits on the Company's participating insurance as permitted by the Laws of the State of Texas.

"ANY SUCH ANNUAL DIVIDEND APPORTIONED TO THIS POLICY IN ANY CALENDAR YEAR, SHALL BE NOT LESS THAN THE CASH DIVIDEND DECLARED BY THE BOARD OF DIRECTORS AND PAID TO THE STOCKHOLDERS OF THE SOUTHERN STATES LIFE INSURANCE COMPANY IN SUCH YEAR ON ____ SHARES OF THE COMMON STOCK OF THE SOUTHERN STATES LIFE INSURANCE COMPANY.

"Executed this the _____ day of _____ 194___ at the office of the Southern States Life Insurance Company, Houston, Texas."

We quote from Cooley's Briefs on Insurance, Volume I, Second Edition, page 164, as follows:

"A common form of life policy is that known as a 'participating policy,' by virtue of the provisions of which the insured is entitled to share in the surplus earnings of the company in proportion to the premiums paid or the amount of his policy. This share in the surplus may be payable to him, at the option of the company, at a certain fixed period or as dividends. In the absence of a statutory provision, the time of distribution of a surplus to policy holders depends on the discretion of the directors of the company, except so far as it may be determined by the charter of the company or valid by-laws (Rothschild v. New York Life Ins. Co., 97 Ill. App. 547). Under a policy entitling the insured to participate in the distributio n of the surpluses according to such principles as might be adopted by the company, the insured has no title to any such surplus until a distribution is made by the officers of the company, and under such provision the company is not required to distribute the entire surplus (Greef v. Equitable Life Assur. Soc., 160 N.Y. 19, 54 N.E. 712, 46 L.R.A. 288, 73 Am. St. Rep. 659, reversing 57 N.Y. Supp. 871, 40 App. Div. 180). If the right of a policy holder to

share in surplus fund is contingent on his continuing a policyholder until the expiration of the certain period, he has no right to sue for a share of such fund until the expiration of the period limited. (Fry v. Provident Savings Life Assur. Soc. (Tenn. Ch. App.) 38 S. W. 116). If the statute provides several methods by which surplus may be distributed, the right of electing which method shall be adopted belongs to the company, and not to the insured (Eastman v. New York Life Ins. Co., 62 N. H. 1).

". . . .

"The rule that participating policies do not create a trust relation, so that a suit for an accounting will be justified, was announced in the comparatively early case of Taylor v. Charter Oak Life Ins. Co., 9 Daly (N.Y.) 489. In later cases arising in New York prior to the repeal of Laws 1892, c. 690, it was held that the right of a policyholder to share in the profits or surplus was not such a right as entitled him to an accounting. . . .

". . . .

"Dividends accruing on a policy of insurance must, of course, be paid according to the contracts under which they accrue (Citizens' Nat. Life Ins. Co. v. Morris, 104 Ark. 288, 148 S.W. 1019). A provision that the policyholder shall be entitled to dividends does not contemplate that the insured may dictate the amount of dividend that shall be declared, or question the result after the discretion of the managers has been exercised in this behalf. The contract is that the insured shall have the benefit of such dividends as the company shall appropriate, and not such as the policyholder or the court may think might have been appropriated. (Fuller v. Knapp (C.C.) 24 F. 100). . . ."

It is stated in Couch's Cyclopedia of Insurance Law, Volume 8, page 6473:

> "In determining the surplus to be credited as dividends to life insurance policies, policies may be divided into classes consisting of those having a common year of issuance, age of applicant, kind of policy, and amount of premiums paid. But, although ordinarily life policies are classed according to the year of issue, or according to the ages of the persons insured, or according to the plan of insurance, for purposes of distribution of surplus and profits among classes, the plan of insurance selected, rather than the date of issue and age of the insured, determines the proper classification; otherwise, the law of averages, so essential to life insurance, is lost or seriously curtailed. And classification for purposes of distribution of surplus or profits must be limited to policyholders who have contributed thereto, and necessarily includes all who have so contributed. Furthermore, under a contract of life insurance which provides that the policyholder shall be entitled to share in the distribution of the company's surplus according to the methods and principles adopted by the company for the distribution of surplus, and under which only such proportion of the surplus as equitably belongs to the policy is to be credited to it and paid to the policyholder, the proportion designated must be ascertained and determined before the policyholder can maintain an action at law to recover any portion of the surplus. And, in case a participating policy provides for an 'equitable share of the divisible surplus,' it will not be considered that the entire profits were intended to be divided among the policyholders, but such a share only as the managers of the company may, in the exercise of their discretion and good faith, declare as profits, they having in view a reasonable and necessary provision for the safety of the company."

We construe said participating clause or certificate not as a guarantee by the company that it will ever declare a dividend to its stockholders, but if it should do so, then its participating policyholders will receive on their policies an amount not less than the cash dividend declared on the number of shares stated in the certificate. The stockholders do not guarantee any stock dividends ever to be paid the policyholders and no stock ever passes to the policyholders. It is noted that the participating clause

or certificate does not state the number of shares of the common stock of the company which will be used as a basis in determining the amount of dividends to be paid. As we understand your request, it is your position that the company could discriminate as to policyholders by inserting a different number of shares of the common stock of the company in the blank contained in the participating clause or certificate. To illustrate: The company might sell two policies of a thousand dollars each and insert in one certificate five shares of stock and in the other ten shares of stock. If the company followed this policy and inserted different shares of ther common stock to be used as a basis in determining the amount of dividends to be paid in identical policies, then such an action would be in violation of Article 5053, Vernon's Annotated Civil Statutes, and Article 578, Vernon's Annotated Penal Code. However, for the purposes of this opinion, we must assume that the company will legally conduct its business and that each policyholder of the same class will be treated like every other policyholder in his class, and that the company will not resort to any discrimination whatsoever. The possibility that the company could discriminate between its policyholders does not justify us in concluding that the company will do so.

Articles 4753 and 5036, Vernon's Annotated Civil Statutes, provide for the calculation of surplus for dividend purposes and forbid the payment of dividends out of funds other than surplus profits as defined in said articles. The participating clause or certificate, above quoted, must, of course, be construed as permitting the payment of dividends only out of such lawful surpluses. Article 4729, Vernon's Annotated Civil Statutes, also forbids the payment of dividends other than from surplus profits and forbids guaranteed dividends to policyholders in excess of the amount of the expense of loading in the premium and provides further that in case of payment of dividends in excess of the amount of the expense loading reserves shall be set up to cover the deficiency in net premium thereby created.

In view of the foregoing, it is our opinion that the participating clause or certificate, quoted above, does not violate any provision of the Insurance Laws of this State. Therefore, having answered your first question as heretofore stated, it is not necessary to discuss the powers of the Board of Insurance Commissioners with reference to

the withdrawal of your approval of such forms and other matters relating thereto as mentioned in your inquiry.

Yours very truly

ATTORNEY GENERAL OF TEXAS

By Ardell Williams

Ardell Williams
Assistant

AW:db

APPROVED
OPINION
COMMITTEE
BY BWB
CHAIRMAN